No. 89-894

In The

Supreme Court of the United States

October Term, 1989

MICHAEL J. CONNOLLY,
MASSACHUSETTS SECRETARY OF STATE, *et al.*,
Petitioners,

v.

SECURITIES INDUSTRY ASSOCIATION, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the First Circuit

BRIEF OF ALASKA, ARIZONA, COLORADO, CONNECTICUT, HAWAII, IDAHO, IOWA, KANSAS, KENTUCKY, LOUISIANA, MAINE, MARYLAND, MICHIGAN, MINNESOTA, MONTANA, NEBRASKA, NEW HAMPSHIRE, NEW MEXICO, NORTH CAROLINA, NORTH DAKOTA, OHIO, OKLAHOMA, OREGON, PENNSYLVANIA, SOUTH DAKOTA, TEXAS, UTAH, VERMONT, VIRGINIA AND WEST VIRGINIA* AS AMICI CURIAE IN SUPPORT OF PETITIONERS

MARY SUE TERRY
Attorney General
of Virginia

H. LANE KNEEDLER
Chief Deputy Attorney
General

WALTER A. MCFARLANE
Deputy Attorney General

**GUY W. HORSLEY, JR.
Senior Assistant
Attorney General

101 North Eighth Street
Richmond, Virginia 23219
(804) 786-6563

*Each sponsored according to Rule 36.4 by its Attorney General pursuant to list of counsel continued inside front cover.

**Counsel of Record for Amici

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

List of Counsel, Continued

HONORABLE DOUGLAS B. BAILY
Attorney General of Alaska

HONORABLE ROBERT K. CORBIN
Attorney General of Arizona

HONORABLE DUANE WOODARD
Attorney General of Colorado

HONORABLE CLARINE NARDI RIDDLE
Attorney General of Connecticut

HONORABLE WARREN PRICE, III
Attorney General of Hawaii

HONORABLE JIM JONES
Attorney General of Idaho

HONORABLE THOMAS J. MILLER
Attorney General of Iowa

HONORABLE ROBERT T. STEPHAN
Attorney General of Kansas

HONORABLE FREDERICK J. COWAN
Attorney General of Kentucky

HONORABLE WILLIAM J. GUSTE, JR.
Attorney General of Louisiana

HONORABLE JAMES E. TIERNEY
Attorney General of Maine

HONORABLE J. JOSEPH CURRAN, JR.
Attorney General of Maryland

HONORABLE FRANK J. KELLEY
Attorney General of Michigan

HONORABLE HUBERT H. HUMPHREY, III
Attorney General of Minnesota

HONORABLE MARC RACICOT
Attorney General of Montana

HONORABLE ROBERT M. SPIRE
Attorney General of Nebraska

HONORABLE JOHN P. ARNOLD
Attorney General of New Hampshire

HONORABLE HAL STRATTON
Attorney General of New Mexico

HONORABLE LACY H. THORNBURG
Attorney General of North Carolina

HONORABLE NICHOLAS J. SPAETH
Attorney General of North Dakota

HONORABLE ANTHONY J. CELEBREZZE, JR.
Attorney General of Ohio

HONORABLE ROBERT H. HENRY
Attorney General of Oklahoma

HONORABLE DAVE FROHNMAYER
Attorney General of Oregon

HONORABLE ERNEST D. PREATE, JR.
Attorney General of Pennsylvania

HONORABLE ROGER A. TELLINGHUISEN
Attorney General of South Dakota

HONORABLE JIM MATTOX
Attorney General of Texas

HONORABLE R. PAUL VAN DAM
Attorney General of Utah

HONORABLE JEFFREY L. AMESTOY
Attorney General of Vermont

HONORABLE ROGER W. TOMPKINS, II
Attorney General of West Virginia

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

TABLE OF AUTHORITIES – Continued

Page(s)

OTHER

INTEREST OF AMICI CURIAE

The decision of the First Circuit Court of Appeals in *Securities Industry Ass'n v. Connolly*, 883 F.2d 1114 (1st Cir. 1989), invalidates regulations of the Commonwealth of Massachusetts designed to insure that purchasers of securities who sign form brokerage agreements containing arbitration clauses do so knowingly and voluntarily. The challenged regulations accomplish this objective by (1) requiring securities brokers to disclose to customers the legal effects of a mandatory arbitration clause in a brokerage agreement, and (2) prohibiting brokerage firms from imposing arbitration agreements upon customers as a non-negotiable condition precedent to opening brokerage accounts. The First Circuit ruled that these regulations were preempted by the Federal Arbitration Act, 9 U.S.C. §§ 2-9 ("FAA" or "the Act"), because they single out arbitration agreements for more stringent treatment than other contractual provisions.

Connolly extends the sweep of federal preemption of the FAA beyond the intent of Congress and, thereby, frustrates the purposes of the Act. The effect of the ruling is to leave the states powerless to protect consumers from being coerced to enter arbitration agreements. Amici curiae have a legitimate regulatory interest in protecting their citizens from an uninformed waiver of other available options for dispute resolution, particularly in industries where market forces do not insure that consumers have adequate information to make a voluntary waiver.

The effect of *Connolly* extends to other industries where economic realities may, in effect, deny consumers

and small businessmen the option of any means of dispute resolution other than an arbitration process dictated by the offeror on a "take it or leave it" basis. Accordingly, amici submit their brief amici curiae supporting the petition for certiorari.

SUMMARY OF ARGUMENT

Amici urge the Court to grant Massachusetts' petition for a writ of certiorari because the decision in *Connolly* misconstrues both Congressional intent in enacting the FAA and the precedent of this Court. While the Court has consistently ruled that the FAA requires the states to honor arbitration agreements between the parties to a contract, it has never ruled that the FAA renders the states powerless to regulate the process by which such agreements are reached in order to avoid coerced arbitration.

The wording of the FAA does not suggest an intent to preempt state regulation of all aspects of the arbitration process. A review of the legislative history of the FAA clearly indicates that Congress intended that the states retain the power to regulate the process of contract formation to ensure that privately negotiated arbitration is consensual rather than coerced.

If the FAA is construed to prohibit states from requiring that arbitrability be negotiable, citizens could be forced to forego state and federal remedies by being coerced into an arbitration process favoring and solely tailored by the offering party. The purpose of the FAA is to enforce arbitration of contractual disputes between the

parties according to the terms to which they have bound themselves. State regulation designed solely to require that the parties freely and knowingly accept those terms furthers rather than frustrates that purpose.

ARGUMENT

I. *CONNOLLY* CREATES A CONFLICT AMONG THE CIRCUITS CONCERNING THE EFFECT OF THE FAA UPON STATE LAWS GOVERNING THE PROCESS OF CONTRACT FORMATION

The *Connolly* court apparently was not impressed with the distinction between state regulation of the *process* of contract formation and the *enforcement* of contracts made by consenting parties for purposes of FAA preemption. Instead, the court found the FAA prohibited the states from adopting *any* regulation which singles out arbitration agreements for special treatment not applicable to other contracts generally, observing that such regulation demonstrates hostility towards arbitration contrary to the FAA. That broad interpretation of the FAA conflicts with the decision of the Fourth Circuit Court of Appeals in *Supak & Sons Mfg. Co., Inc. v. Pervel Industries, Inc.*, 593 F.2d 135 (4th Cir. 1979), wherein the court premised its analysis of an FAA challenge to a state law of contract formation with the observation that the FAA "does not displace state law on the general principles governing formation of the contract itself," and "[b]y its terms, § 2

[of the FAA] does not apply until the arbitration in question is determined to be part of the contract." 593 F.2d 137.

Plaintiff in *Supak* sought unsuccessfully to invoke arbitration procedures to resolve a contractual dispute under a sales contract governed by the Uniform Commercial Code. Plaintiff relied upon an oral agreement with defendant to arbitrate disputes; defendant argued that arbitration was not available because state law deemed the addition of arbitrability a "material alteration" of a contract requiring written confirmation by the parties. The court held that the FAA does not preempt the states from limiting arbitrability in this manner, suggesting that state laws governing contract formation would be preempted under the FAA only if they were solely applicable to arbitration *and* placed an "unreasonable burden on the parties' ability to commit themselves to arbitration." *Id.*[1]

The question presented by this petition is whether the *Connolly* analysis (*any* specific state regulation of arbitrability is presumptively preempted by the FAA) or that of *Supak* (FAA preempts only state law which either impedes enforcement of arbitration agreements or which unreasonably burdens the parties' ability to consent to

---

[1] Consistent with *Supak*, a federal district court rejected an FAA preemption challenge to Virginia law requiring that arbitration clauses in motor vehicle franchise contracts be negotiable. *Saturn Distribution Corp. v. Williams*, 717 F.Supp. 1147 (E.D. Va. 1989). That case is currently on appeal to the Fourth Circuit Court of Appeals.

arbitration) is the correct interpretation of the FAA. It is a question which this Court has not yet considered. More importantly, it is vitally significant to the power of states to regulate contractual relationships in order to protect unwary consumers against coerced waivers of judicial or administrative means of dispute resolution.

II. THE FAA NEITHER EXPRESSLY NOR IMPLICITLY PREEMPTS ALL STATE REGULATION OF ARBITRATION

Whether the FAA preempts the states from regulating arbitration clauses in contracts of adhesion is the dispositive legal issue raised by this petition. Any analysis of a claim of federal preemption must begin with the premise that there is a presumption against preemption. "Preemption of state law by federal statute or regulation is not favored 'in the absence of persuasive reasons. . . .' " *Chicago & North Western Transportation Corp. v. Kalo Brick & Tile Co.*, 450 U.S. 311, 317 (1981) [*quoting Florida Lime & Avocado Growers, Inc. v. Paul*, 373 U.S. 132, 142 (1963)].

Whether federal law preempts state regulation is determined by Congressional intent, which may be found by (a) explicit statutory language, (b) implication arising from the fact that the federal law is so pervasive as to occupy the entire field of regulation to the exclusion of supplementary state regulation, or (c) evidence that the challenged state law conflicts with, or stands as an obstacle to, federal law. As the *Connolly* court concedes, there is neither explicit preemption language in the FAA nor any indication that Congress intended to exclude the

states from the field of regulation of arbitration. Accordingly, *Connolly* is based solely upon a determination that a state regulation requiring that an agreement to arbitrate be voluntary conflicts with the intent of FAA. *Connolly* is wrong because it ignores the legislative history of the FAA that clearly indicates that the challenged regulations are consistent with the intent of the drafters of the FAA.

III. THE LEGISLATIVE HISTORY OF THE FAA BELIES THE CONTENTION THAT THE STATES' REGULATION OF ARBITRABILITY IS INCONSISTENT WITH THE FAA

A divided Court in *Southland Corp. v. Keating*, 465 U.S. 1 (1984), ruled that the FAA withdrew the power of the states to require a judicial forum for resolution of contract disputes. Justice Stevens, in dissent, concluded that Congress did not intend to require states to honor arbitration agreements in franchise relationships where the relative disparity in bargaining position between the parties warranted regulatory protection for the weaker party. While Justice Stevens' argument did not persuade the majority, his view, supported by the legislative history of the FAA, that Congress assumed there is a role for state regulation of arbitrability is echoed in this Court's recent decision in *Volt Information Sciences, Inc. v. Board of Trustees*, 109 S.Ct. 1248 (1989).

That legislative history is extensive and consistently supports the validity of the Massachusetts regulations. It suggests that the intent of Congress in enacting the FAA was modest. Rather than having as its purpose the preemption of state regulation of arbitration, the FAA was

designed simply to overcome traditional judicial resistance to the enforcement of voluntary arbitration agreements between contracting parties.

The official reports of the two bills, which ultimately were codified as the FAA (H.R. 646 and S. 1005), underscore the limited scope of the legislation. Congressman Graham, who authored the House Report of H.R. 646, summarized the effect of the bill for his colleagues as follows:

> Arbitration agreements are purely matters of contract and the effect of the bill is simply to make the contracting party live up to his agreement. He can no longer refuse to perform his contract when it becomes disadvantageous to him.

Report No. 96 on H.R. 646, 68th Cong., 1st Sess. (Jan. 24, 1924).

The Senate report on its counterpart to H.R. 646, S. 1005, similarly stresses the enforcement of *voluntary* agreements as the impetus behind the new law:

> The record made under the supervision of this society [referring to the Arbitration Society of America] shows not only the great value of voluntary arbitrations but the practical justice in the enforced arbitration of disputes where written agreements for that purpose have been voluntarily and solemnly entered into.

Report 536 on S. 1005, 68th Cong., 1st Sess. (May 14, 1924).

While the Act was carefully considered over two sessions of Congress, it passed without substantial opposition. This lack of opposition may be explained by the modest purpose of the Act – to require that parties who

have agreed to arbitrate their disputes honor that agreement.

Fears by members of Congress that the legislation would supplant state law was addressed by its supporters. During the Congressional hearings on the FAA in 1924, one of the chief draftsmen of the legislation, Mr. Julius Cohen, submitted a brief to two Congressional subcommittees stating that the proposed legislation would not supersede state law on contract formation:

> It [the FAA] is no infringement upon the right of each State to decide for itself what contracts shall or shall not exist under its laws. To be sure whether or not a contract exists is a question of the substantive law of the jurisdiction wherein the contract was made.

Joint Hearings on S.B. 1005 and H.R. 646 Before the Subcommittees of the Committees on the Judiciary, 68th Cong., 1st Sess. (1924) at 37 (the "1924 Hearings"). There is nothing in the record of those hearings to suggest that the Act would affect the states' power to regulate the process of contract formation.

Moreover, the transcripts of the Congressional hearings reflect that the FAA was not intended to require the states to tolerate coerced arbitration through adhesive contracts. During hearings on the proposed FAA in 1923, Senator Walsh expressed his concern that arbitration clauses often appeared in "take it or leave it" contracts. A proponent and drafter of the FAA, W.H.H. Piatt, assured Senator Walsh that it was not the intention of the bill to force arbitration on unwilling parties and he "would not favor any kind of legislation that would permit the forcing a man to sign that kind of a contract." *Hearings on S.B.*

4213 and S.R. 4214 before the Subcommittee of the Senate Committee on the Judiciary, 67th Cong., 4th Sess. (1923) at 10.

Similarly, during the Congressional hearings in 1924, Julius Cohen was asked to respond to the contention that arbitration clauses are used by railroads in "take it or leave it" contracts with shippers. He responded that there are statutory safeguards to protect individuals against the harsh effects of contracts of adhesion, stating, by way of illustration, "you can not get a provision into an insurance contract to-day (sic) unless it is approved by the insurance department." 1924 Hearings at 15. Mr. Cohen's comment is consistent with the simple proposition advanced by Massachusetts in *Connolly:* by enacting the FAA, Congress did not intend to deny the states their regulatory prerogative to prevent coerced arbitration through regulation of the process of contract formation. Moreover, Mr. Cohen's written comments provided to Congress reinforce the notion that the states could protect their citizens from unwanted arbitration in adhesive contracts without offending the FAA:

> There is no disruption therefore by means of the Federal bludgeon to force an individual State into an unwilling submission to arbitration enforcement. The statute cannot have that effect.

1924 Hearings at 40. *Connolly,* however, interprets the FAA in such a way as to have precisely "that effect" by restricting the states' authority to require that arbitration be consensual.

IV. *CONNOLLY* MISCONSTRUES PRECEDENT OF THIS COURT IN RULING THAT THE FAA PROHIBITS REASONABLE STATE REGULATION OF ARBITRATION

The result in *Connolly* was influenced by rulings of this Court reflecting an expansive reading of the FAA. In none of those cases, however, was there any doubt that the parties had fairly contracted to arbitrate their disputes. Instead, the Court was merely asked to, and consistently did, rule that agreements to arbitrate are enforceable and that states are preempted by the FAA from denying enforcement of valid agreements to arbitrate.[2]

---

[2] *See Rodriguez De Quijas v. Shearson/American Express, Inc.*, 109 S.Ct. 1917 (1989) (customer agreement with brokerage house contained a clause to arbitrate controversies relating to investment accounts); *Perry v. Thomas*, 482 U.S. 483 (1987) (state law cannot invalidate an employment contract requiring arbitration of dispute with employer); *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987) (customer agreement with brokerage house contained a clause to arbitrate controversies relating to investment accounts); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614 (1985) (distributor contract for the sale of automobiles had a provision that all disputes would be settled by arbitration); *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213 (1985) (customer agreement with brokerage house contained a clause to arbitrate any controversy between the parties relating to the agreement); *Southland Corp. v. Keating, supra* (states may not require judicial forum for resolution of contract disputes where parties have contracted for arbitration); *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1 (1983) (construction contract contained a clause to arbitrate all claims and disputes relating to the agreement); *Scherk v. Alberto-Culver Co.*, 417 U.S. 506 (1974)

(Continued on following page)

That there are limitations upon FAA preemption of state laws affecting arbitration was recognized by this Court in *Volt*. In *Volt*, the Court upheld a California procedural rule permitting a stay of arbitration pending resolution of related litigation involving third parties who were not bound by the arbitration agreement.

Volt's expression of the purpose of the FAA demonstrates the error of the court in *Connolly*. The majority noted that there is no federal policy favoring mandated arbitration:

> The FAA contains no express pre-emption provision, nor does it reflect a congressional intent to occupy the entire field on arbitration.
>
> * * *
>
> It simply requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms.
>
> * * *
>
> Arbitration under the Act is a matter of consent, not coercion, and parties are generally free to

---

(Continued from previous page)

(contract for the sale of an international business had a clause providing that any controversy arising out of the agreement would be referred to arbitration); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117 (1973) (New York Stock Exchange form agreement between employer and employee contained a provision whereby the parties agreed to arbitrate controversies arising out of termination of employment); *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395 (1967) (consulting agreement had a clause by which the parties agreed that any controversy arising out of the contract would be settled by arbitration).

> structure their arbitration agreements as they see fit.

109 S.Ct. 1254-5. The Massachusetts regulations do not undermine these principles; indeed, by insuring that an arbitration agreement is truly "privately negotiated," those regulations promote the policies underlying the FAA.

The effect of *Connolly* is to make arbitration a sacred cow which cannot be subject to reasonable regulation by the states for consumer protection. This position is simply not justified by the FAA or Supreme Court precedent. *Volt* removes any doubt that there is room for state regulation of arbitration. The appropriate inquiry for purposes of preemption analysis is whether state regulation of arbitration "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." *Hines v. Davidowitz*, 312 U.S. 52, 67 (1941).

The effectiveness of contractual arbitration as a means of dispute resolution is premised upon the assumption that the parties knowingly and voluntarily have chosen to be bound by the arbitral process. The *Connolly* decision is fatally flawed because it ignores this principle in adopting a *per se* rule invalidating any state regulation affecting arbitration, regardless of the nature of the state's interest in regulating a particular industry.

V. THE STATES HAVE A LEGITIMATE INTEREST IN REQUIRING THAT ARBITRABILITY BE NEGOTIABLE

The rule of *Connolly* establishes precedent which threatens to invalidate a large spectrum of state

regulation. While *Connolly* involves only the securities industry in Massachusetts, under the law of the case any state regulation which singles out arbitration for special treatment is vulnerable to an FAA preemption challenge.

Although this Court has determined that the states may not eliminate arbitration as an option for dispute resolution, it has recognized that Congress has determined that arbitration may not be appropriate for the resolution of some disputes arising under federal law.[3] This recognition of the differences between judicial and

---

[3] This Court on several occasions has determined that the "*proper relationship* between federal courts" and alternative dispute resolution favors granting litigants access to the former. *Alexander v. Gardner-Denver Co.*, 415 U.S. 36, 38 (1974) (emphasis added). In *Alexander*, the Court found that "the fact-finding process in arbitration usually is not equivalent to judicial fact-finding. . . .[A]nd the rights and procedures common to civil trials . . . are often severely limited or unavailable." *Id.* at 57-58. The Court concluded that "the federal policy favoring arbitration of labor disputes and the federal policy against discriminatory employment practices can best be *accommodated*" by allowing a Title VII plaintiff access to federal courts regardless of whether the dispute was first litigated in arbitration. *Id.* at 59 (emphasis added). *See also McDonald v. West Branch*, 466 U.S. 284 (1984) (wherein the Court ruled that federal courts should not give any effect to arbitration resolutions of 42 U.S.C. § 1983 actions); *Barrentine v. Arkansas-Best Freight System, Inc.*, 450 U.S. 728, 744 (1981) (wherein the Court, over the dissent of Chief Justice Burger in which he extolled the virtues of arbitration, noted again that "arbitral procedures [are] less protective of individual statutory rights than are judicial procedures" and held that employees have a right to bring minimum wage claims under the Fair Labor Standards Act in court).

non-judicial procedures cannot be ignored by the states any more than it can be ignored by the federal government. Subject only to the limitation that state regulation cannot frustrate the objectives of the FAA, the states must be free to consider the differences between arbitration and judicial procedures in regulating the process of contract formation.

That it may be appropriate for the states to subject arbitration to special conditions through laws governing contract formation was recognized by the Fourth Circuit Court of Appeals in *Supak*. The court ruled that it is permissible under the FAA for a state to define the addition of arbitrability to a commercial contract as a material alteration requiring written consent by both parties. Under *Connolly*, the state rule would not have survived, because it "singles out" arbitration for special treatment not applicable to other contractual provisions.

The implications of the First Circuit ruling are staggering. While arbitration has gained recognition as an acceptable alternative to judicial procedures, the states have an interest in reducing the risk that their citizens would unknowingly or unwillingly forfeit an option of judicial relief *or* administrative remedies provided by state law. This interest is particularly important in industries where market forces do not provide opportunities for informed waivers by consumers.

The states' general acceptance of arbitration as an efficient and inexpensive means of resolving contractual disputes has been accompanied in many instances by regulations designed to protect the consumer from an uninformed or coerced waiver of rights to access to a

judicial forum. For example, arbitration of medical claims, while gaining widespread acceptance, is subject to certain disclosure requirements in many states.[4] Similar concerns have prompted some states to regulate arbitration imposed through adhesive contracts in motor vehicle franchise agreements.[5] Privately negotiated arbitration is desirable only if it is mutually acceptable to all parties who would be bound by it. Otherwise, it has the potential of becoming a tool by which those who dominate an industry may exert their economic strength to avoid rather than embrace a fair and impartial resolution of contractual disputes.

CONCLUSION

The *Connolly* decision presents a legal issue which has not yet been addressed by this Court and which is the subject of disagreement among the circuits. If left undisturbed, the ruling threatens to undermine seriously the legitimate interests of the states in assuring that contractual arbitration is truly a matter of consent, not coercion.

---

[4] *See* examples given in Massachusetts' petition for certiorari at 28-30.

[5] *See Saturn Distribution Corp. v. Williams* (n. 1).

Accordingly, amici urge that the Court grant a writ of certiorari to decide this significant question.

Respectfully submitted by the
Commonwealth of Virginia
on behalf of Amici Curiae,
by her Counsel:

MARY SUE TERRY
Attorney General of Virginia

H. LANE KNEEDLER
Chief Deputy Attorney General

WALTER A. MCFARLANE
Deputy Attorney General

*GUY W. HORSLEY, JR.
Senior Assistant Attorney General

101 North Eighth Street
Richmond, Virginia 23219
Telephone: (804) 786-6563

*Counsel of Record for Amici